A Potential Income Alternative in a Rising Rate Environment

Today's investors face few options for generating income in a rising interest rate environment. Lofty stock valuations and heightened market uncertainty would normally prompt investors to seek the relative safety of fixed-income securities as a way to generate income and preserve capital. However, with Treasury yields continuing to hover near historic lows, rising interest rates—with the Federal Reserve recently signaling at least three hikes in 2018—provide a headwind for most fixed-income investments. Senior secured loans offer a potentially compelling solution.

What are senior secured loans?

Senior secured loans are debt obligations generally issued by non-investment grade businesses. These loans are usually "secured" by a company's assets, and are typically used to fund a company's growth or cover general operating expenses. The borrower is the company itself, not a bank.

What makes these loans different? Senior secured loans can diversify an investor's income strategy, help preserve capital, and serve as a hedge against rising interest rates. Because of these attributes, the senior loan market has grown over 250 percent in the last decade, today exceeding $915 billion.[1,2] With that growth has come a greater breadth of investor into the sector.

Loans can range from $50 million, considered small by market standards, to greater than $10 billion, issued by some of the country's largest businesses. Since the late 1980s, banks and other financial institutions have sold portions of these loans to institutional investors as part of a syndication process.

The regulations stemming from the 2008 global financial crisis spurred changes in the senior secured loan market. These restrictions have limited borrowing opportunities for many small and medium-sized American businesses—the cornerstone of our economy—from traditional bank channels. These businesses have turned to alternative sources of financing, such as Business Development Companies (BDCs) and private lenders, creating new opportunities for investors to access the loan asset class.

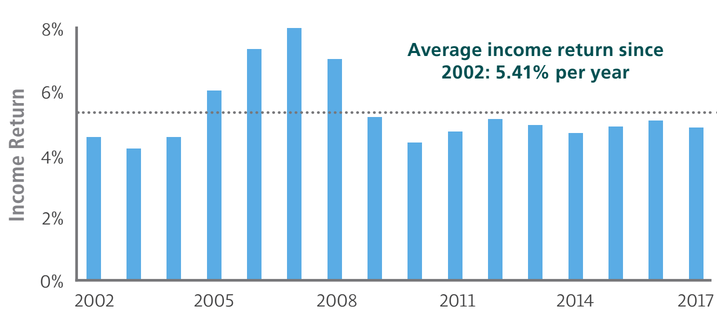
Focusing on income in an income-starved environment

Investors are facing a challenging investment backdrop, particularly when looking to generate income. With the stock market hitting all-time highs, leaving little room for incremental upside, many investors are hesitant to increase their equity exposure.

After years of quantitative easing by central banks, which utilized near-basement level rates to stimulate economic growth, the bond market now faces a new set of difficulties.

Senior secured loans have produced consistent income through varying interest rate environments, averaging a 5.41 percent income return since 2002 (Figure 1). This consistency also brings a measure of downside protection should interest rates change.

Figure 1. **Loan Market Income Return**



Source: Bloomberg - S&P/LSTA Leveraged Loan Index Interest Index, 12/31/02–12/31/17.

[1] Credit Suisse. 12/31/15.
[2] Credit Suisse Leveraged Loan Index. 6/30/16.

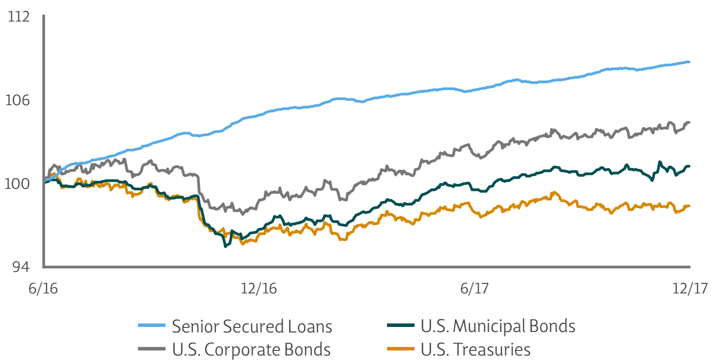
Floating vs. fixed coupons

With interest rates starting to normalize, senior secured loans offer a potential hedge against rising rates.

The Federal Reserve raised its key interest rate three times in 2017 and signaled at least three more hikes on the horizon in 2018. Investors must be prepared for a changing interest rate environment, especially those with significant bond exposure.

Figure 2 examines how fixed-income asset classes handled interest rates rising over 1.0 percent since early July 2016. In this environment, senior secured loans outperformed investment-grade bonds, U.S. treasuries, and U.S. municipal bonds.

Figure 2. **Performance of Credit Assets as Rates Rise**



Source: Bloomberg - S&P/LSTA Leveraged Loan Index (Senior Secured Loans), Bank of America Merrill Lynch Corporate Bond Index (U.S. Corporate Bonds), Bank of America Merrill Lynch U.S. Municipal Securities Index (U.S. Municipal Bonds), Bank of America Merrill Lynch U.S. Treasury Index (U.S. Treasuries), 6/1/16-12/31/17. **An investment cannot be made directly in an index.**

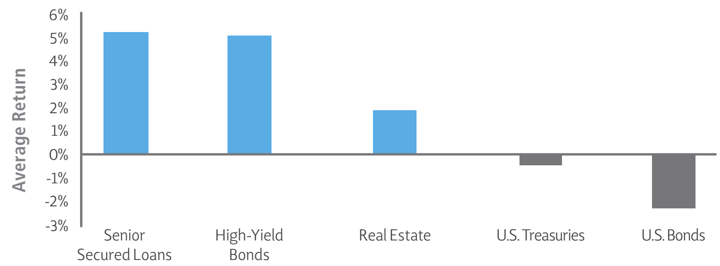
Why the stark difference in performance as interest rates climbed? The quick answer: floating- versus fixed-rate coupons.

Bonds pay interest income at a fixed rate for the life of the bond, which presents little interest rate risk during periods of steady or declining rates. However, rising interest rates are like kryptonite for fixed-coupon bond investors, eroding bonds' market value. This is problematic for owners of long-maturity bonds who face the unenviable choice of either watching the value of their bonds steadily erode, or selling them off at a discount, often resulting in a loss of principal.

Conversely, senior secured loans pay interest at a floating rate, allowing them to potentially benefit from rising rates.

Figure 3 points out this important dynamic. Senior secured loans have produced more consistent returns compared to real estate, U.S. treasuries, and U.S. bonds during periods of rising interest rates dating back to 2002.

Figure 3. **Average Return During Rising Interest Rates**



Source: Bloomberg - S&P/LSTA Leveraged Loan Total Return Index (Senior Secured Loans), Bank of America Merrill Lynch U.S. High Yield Index (High-Yield Bonds), NCREIF Property Index (Real Estate), Bank of America Merrill Lynch 1–3 Year U.S. Treasury Index (U.S. Treasuries), and Barclays U.S. Aggregate Total Return Value Index (U.S. Bonds), 12/31/17. Periods shown represent periods during which the U.S. 10-year treasury yield increased by 50 basis points or more. The periods include: 11/7/01–4/1/02, 6/13/03–9/2/03, 3/22/04–6/14/04, 6/27/05–6/27/06, 3/17/08–6/13/08, 12/30/08–6/10/09, 11/30/09–4/5/10, 10/8/10–2/8/11, 9/22/11–10/27/11, 1/31/12–3/19/12, 7/24/12–9/14/12, 5/1/13–12/31/13, 1/30/15–3/6/15, 4/17/15–6/10/15, 7/8/16–12/15/16.

How is a senior secured loan's floating rate calculated? It is based on a nominal credit spread over a short-term base rate, typically a 3-month LIBOR (London Interbank Offered Rate).

The nominal spread is simply the amount of interest a borrower will pay over the base rate. It is typically a fixed amount of interest expressed in basis points (bps). While the value of loans can change, particularly during periods of market volatility, investors earn a fixed spread over the benchmark throughout the life of the loan. However, the value of the benchmark is floating, providing the mechanism that enables loans to benefit from rising rates.

Roughly 90 percent of corporate loans have some sort of "LIBOR floor," typically set at 1.0 percent. If the current market rate for 3-month LIBOR was below 1.0 percent, investors would earn 1.0 percent plus their loan's spread.

The upside for investors comes when the benchmark rises above 1.0 percent. If interest rates rise, LIBOR also rises, therefore increasing the interest paid to the investor.

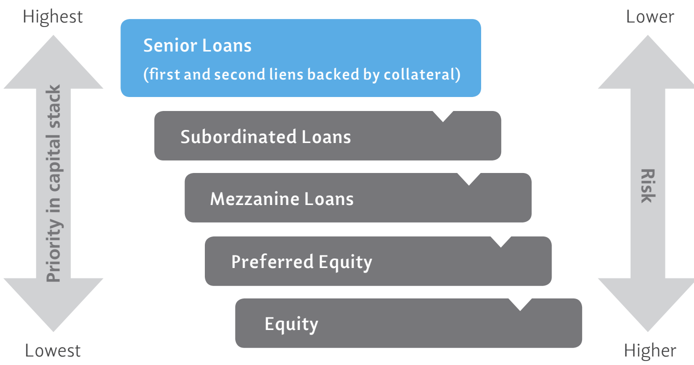
Once interest rates move, it typically takes 60 days or less for the rate on a senior loan to adjust. Because of this short window, senior secured loans are known to be very responsive to short-term interest rate movements.

What does this mean for investors? A senior secured loan's floating-rate coupon makes it a potential interest rate hedge that could provide consistent income through various market cycles.

Loans' seniority provides security

Senior secured loans sit at the top of a company's capital structure and are typically backed by some or all of a borrower's physical assets, such as property and equipment. These loans represent senior obligations of the issuer, ahead of all junior capital, including bonds and equity, making the asset class less volatile (Figure 4).

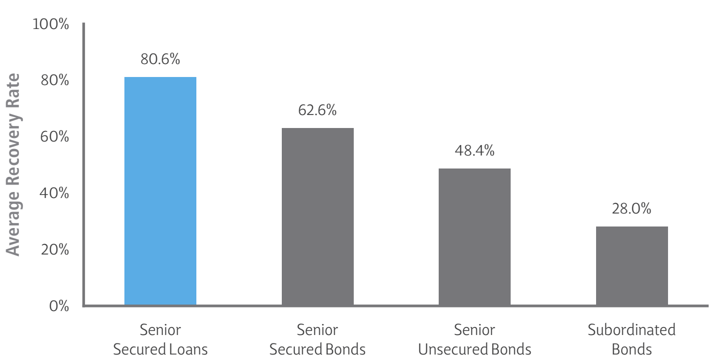
Figure 4. **Typical Company Capital Structure**



If the borrowing company becomes distressed and is forced into bankruptcy, senior loans are first in line to be paid back. Typically, a loan must receive all of its interest and principal before junior capital receives a penny of recovery.

While there is no guarantee that an investor in senior secured loans will get paid back in full, the fact that these loans are secured means that they enjoy much higher recovery rates than unsecured or subordinated bonds in the event of default. As Figure 5 highlights, senior secured loans have historically recovered around 80 cents on the dollar compared to 49 cents on the dollar for unsecured bonds and 28 cents on the dollar for subordinated bonds.

Figure 5. **Average Corporate Debt Recovery Rates**



Source: Moody's Investor Service. Annual Default Study. 2/15/17.

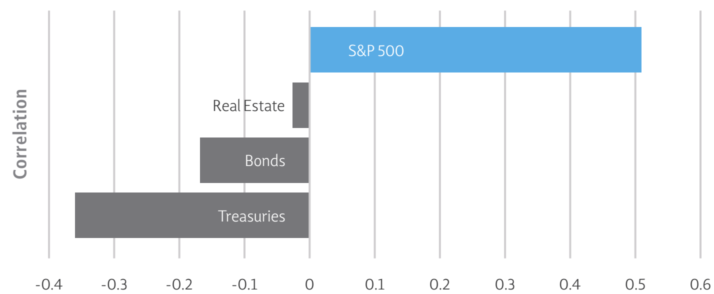
Lowering portfolio volatility

Senior secured loans are not highly correlated to traditional asset classes, such as equities and bonds. By investing in corporate credit, investors are attempting to lower overall portfolio risk through diversification. Theoretically, investments with a correlation of +1.0 will react in the exact same way as the market, while two investments with a correlation of -1.0 will move in opposite directions.

As Figure 6 indicates, senior secured loans have correlations ranging from -.40 to .50 with treasuries, bonds, real estate, and equities.

These relatively low correlations give investors the ability to add non-correlated assets to their broader investment portfolio and potentially reduce overall portfolio volatility.

Figure 6. **Correlation of Leveraged Loan Index vs. U.S. Treasuries, U.S. Corporate Bonds, and Real Estate**



Source: Bloomberg - Bank of America Merrill Lynch U.S. Treasury Index (U.S. Treasuries), Barclays U.S. Aggregate Total Return Value Index (Investment Grade Bonds), NCREIF Property Index (Real Estate), S&P 500 Total Return Index (Equities), 12/31/96–12/31/17. Diversification does not ensure profit or guarantee against loss.

Summary

Senior secured loans have produced consistent income through various interest rate cycles. With the stock market at premium valuation and bond investors facing income challenges due to rising interest rates, senior secured loans could provide consistent income with a measure of downside protection.

A loan's floating-rate coupon pays out higher incremental income as interest rates rise. As interest rates move, it typically takes 60 days or less for the floating rate on a senior secured loan to catch up to the change. This interest rate sensitivity makes these loans very responsive in a rising rate environment. In comparison, a fixed-coupon, long-duration bond's principal erodes as rates rise, making new bonds with a higher coupon more attractive.

Seniority in the capital structure brings security in the event of default. A senior secured loan's top position helps preserve more of an investor's capital in this situation. Loans have historically recovered 80 cents on the dollar in default compared to 28-to-49 cents on the dollar for unsecured or subordinated loans.

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